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Comments on OECD discussion draft on revisions to Chapter I of the Transfer Pricing Guidelines

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Andrew Hickman
Head of Transfer Pricing Unit
Centre for Tax Policy and Administration
OECD

5 February 2015

Sent via email to: transferpricing@oecd.org

Dear Mr. Hickman,

We hereby provide you with comments on the “discussion draft on revisions to Chapter I of the Transfer Pricing Guidelines (including risk, recharacterisation, and special measures)”. Our main comments concern the issue of non-recognition.

1. The guidance in section D.4. of the discussion draft concerns non-recognition of a *transaction*. Is it also possible to disregard ‘merely’ *one or more terms other than the price, i.e. structural terms* of a transaction? Consistent with the guidance in par. 1.64 and par. 1.65 of the Guidelines 2010 we recommend an affirmative answer.

2. The guidance in par. 82, 89 and 92 in section D.4. of the discussion draft indicates that a transaction that lacks the fundamental economic attributes of arrangements between unrelated parties *must* be disregarded. Does a tax administration have a discretionary competence or is it obliged to disregard a transaction that lacks the fundamental economic attributes of arrangements between unrelated parties?

3. Is non-recognition of a transaction required/possible (see comment 2), solely because it does not exhibit the fundamental economic attributes of arrangements between unrelated parties (‘an objective test’). Or should the associated enterprise *actually be aware* of the fact that the transaction does not exhibit the fundamental economic attributes of arrangements between unrelated parties (‘a subjective test’)? Or is it necessary that the associated enterprise *reasonably should have been aware* of the fact that the transaction does not exhibit the fundamental economic attributes of arrangements between unrelated parties (‘an objectified subjectivity test’)?

4. Conceptually, non-recognition of a transaction or non-recognition of (contractual) structural terms is possible for two qualitatively different reasons:

1. The factual behavior of the parties does not conform to the terms of the contract;
2. The transaction or the (contractual) structural terms would not have been agreed between independent enterprises.

In the discussion draft no (explicit) distinction is made between these two reasons for non-recognition. Disregarding the transaction or disregarding (contractual) structural terms for the first reason could be described as *factual non-recognition*. Strictly speaking, this option does not come within the purview of the arm’s length principle, since no comparison is made with independent enterprises. Disregarding the transaction or disregarding (contractual) structural terms for the second reason could be described as *arm’s length non-recognition*.¹ We suggest to add the distinction between these two qualitatively different reasons for non-recognition and to use the aforementioned terminology in referring to these reasons for non-recognition.

5. We request that consideration is given in section D.4. of the discussion draft to the fact that associated enterprises may conduct transactions and may agree on contractual (structural) terms that do not maximize the integrated (combined) pre-tax profit, since managers are *boundedly rational*

¹ The terminology *factual non-recognition* and *arm’s length non-recognition* is not used by the OECD. It is inspired by the distinction of the ‘factual substance prong’ and the ‘arm’s length prong’ of ‘economic substance’ in A. Bullen, *Arm’s Length Transaction Structures: Recognizing and Restructuring Controlled Transactions in Transfer Pricing*, Online Books IBFD 2011.

instead of *fully rational*. In short, managers may not be fully informed about all available options and they have limited cognitive capacities for processing the information that is available to them. Non-profit maximizing transactions and non-profit maximizing contractual (structural) terms that are due to *bounded rationality* are not due to the relatedness between the associated enterprises and *arm's-length non-recognition* is therefore not appropriate.

6. With respect to *arm's length non-recognition* we recommend that *either*:

1. The guidance in the Guidelines 2010 is maintained and clarified, namely that transactions or (contractual) structural terms may be disregarded if and only if for at least one of the associated enterprises a realistically available option that is clearly more attractive exists; *or*
2. In the Guidelines the guidance in the discussion draft is adopted that a transaction must be disregarded if and only if it lacks the fundamental economic attributes of arrangements between unrelated parties. In this case we suggest to add that (contractual) structural terms must/or may (see comment 2) be disregarded (see comment 1) as well. Additionally, we suggest to add that a transaction or (contractual) structural terms lack the fundamental economic attributes of arrangements between unrelated parties if for at least one of the associated enterprises a realistically available option that is clearly more attractive exists.

Irrespective of the option chosen, we suggest to add that a realistically available option is clearly more attractive if its expected long-term profit is clearly higher than the expected long-term profit of the transaction or the (contractual) structural terms. Furthermore, we suggest to add that *arm's length non-recognition* is only allowed if the associated enterprise *reasonably should have been aware* of a realistically available option that is clearly more attractive ('an objectified subjectivity test').²

7. The guidance in the discussion draft is not entirely clear on the relationship between the *control over a risk* and the *financial capacity to bear a risk*. Is the *financial capacity to bear a risk* a relevant but not determinative factor in determining whether the allocation of risks in a controlled transaction is arm's length, as seems to be suggested in par. 66 (first sentence) of the discussion draft? Or is the *control over a risk* the single relevant factor, as seems to be suggested in par. 78 (last sentence)?

We hope that these comments will be of use for you.

Yours sincerely,

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² There are problems with both a subjective and an objective test. Under a subjective test, an enterprise may claim not to have been aware of a realistically available option that is clearly more attractive, even though in fact, it was aware of such an option. Furthermore, an enterprise may truly not have been aware of a realistically available option that is clearly more attractive, because it had intentionally investigated no or very few alternatives to the transaction actually undertaken. In an objective test, non-profit maximizing transactions and non-profit maximizing contractual (structural) terms that are not due to the relatedness between the associated enterprises may – contrary to the aims of the arm's length principle – be disregarded (see comment 5). An objectified subjectivity test does not suffer from the problems of the subjective test. The problem of the objective test is mitigated in the objectified subjectivity test by the notion that a realistically available option must be *clearly* more attractive and its expected long-term profit must be *clearly* higher. *Arm's length non-recognition* is not allowed if managers, for example due to *bounded rationality*, do not notice a realistically available option that is *slightly* more attractive.